

**Office of Chief Counsel  
Internal Revenue Service  
Memorandum**

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subject: Applicability of Mitigation Provisions to Net Operating Losses

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ISSUE

Whether the mitigation provisions, found in I.R.C. §§ 1311 through 1314, may be applied to allow a barred refund after an audit resulted in an increased net operating loss properly carried to a closed year.

FACTS

Examination is currently examining an S Corporation<sup>1</sup> and its sole shareholder, the taxpayer, for taxable years 2005 and 2006 ("Exam"). For taxable year 2005, both the S Corporation's Form 1120S, "U.S. Income Tax Return for an S Corporation," and the taxpayer's Form 1040, "U.S. Individual Income Tax Return," reported a net

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<sup>1</sup> An S Corporation is a small business corporation for which an election has been made under section 1362(a) for the taxable year. I.R.C. § 1361(a)(1).

operating loss (NOL). The taxpayer's NOL reported on his Form 1040 for year 2005 was carried back to, and completely absorbed by, taxable years 2003 and 2004.

For taxable year 2006, both the S Corporation's Form 1120S and the taxpayer's Form 1040 reported an NOL. The taxpayer's NOL reported on his Form 1040 for year 2006 was carried forward by the shareholder to taxable year 2007 and was absorbed in taxable year 2008. The 2006 Form 1040 included a statement in accordance with I.R.C. § 172(b)(3), making an irrevocable election to forego the carryback of the net operating losses reported in 2006.

During the Exam, the revenue agent made adjustments to the Forms 1120S and Forms 1040. For taxable year 2005, the revenue agent's adjustments resulted in income to the S Corporation and the shareholder. For taxable year 2006, the revenue agent's adjustments resulted in an increased loss for the S Corporation. This created an increased NOL and Alternative Minimum Tax ("AMT") NOL on the shareholder's Form 1040 for taxable year 2006. Due to the irrevocable election made by the taxpayer pursuant to section 172(b)(3), this increased loss must be carried forward.

The Service did not open the year 2007 Forms 1120S and 1040 for examination. The statute of limitations for assessing tax on the Form 1040 and the Form 1120S for taxable year 2007 expired on April 15, 2011. The statute of limitations for claiming a refund for year 2007 also expired on April 15, 2011. The Form 1040 for taxable year 2007 showed negative taxable income and no income tax; however, the return also showed AMT due (such amount was self-reported, and assessed by the Service).

A revenue agent's report ("RAR") was issued to the shareholder in February 2011, showing the NOL and AMT NOL from taxable year 2006 carried back to taxable years 2004 and 2005. The report showed the NOL and AMT NOL absorbed in full in 2004 and 2005. Neither the shareholder nor the agent signed the RAR. The result of the Exam will not be the result proposed in the RAR.

In taxable year 2007, the taxpayer had negative taxable income; however, the taxpayer had paid AMT. Carrying the 2006 losses forward pursuant to the taxpayer's election, the taxpayer's AMT for taxable year 2007 would be zero. But for the statute of limitations ("SOL"), the taxpayer would receive a refund in the amount of the AMT paid for taxable year 2007. However, the SOL for assessment of tax liability and for claiming a refund for such year is now closed. Examination has asked whether the mitigation provisions of the Code apply to the facts presented such that the taxpayer can receive a refund of the AMT paid in taxable year 2007.

### LAW AND ANALYSIS

Section 172(a) authorizes a net operating loss (NOL) deduction. An NOL is defined as the excess of allowable deductions over gross income, with specified modifications. I.R.C. §§ 172(c) and (d). The modifications for purposes of computing

an NOL include an exclusion of personal exemptions and non-business deductions of taxpayers other than corporations (except to the extent of income that is not derived from a trade or business). I.R.C. §§ 172(d)(3) and (4). Section 172(a) allows an NOL deduction for the aggregate of NOL carrybacks and carryovers to the taxable year. Section 172(b)(1)(A) generally provides that the period for a carryback is 2 years and that the period for a carryover is 20 years. A taxpayer may elect to waive the carryback period, but only if he files an election to do so by the due date (including extensions) of the return for the year in which the carryback NOL is generated. I.R.C. § 172(b)(3). Otherwise, the NOL must be carried to the earliest of the taxable years to which it may be carried, and it offsets taxable income for that year. I.R.C. §172(b)(2). In the case of AMT NOLs, the rules for those NOLs run parallel. See I.R.C. § 56; Allen v. Commissioner, 118 T.C. 1, 16–17 (2002).

In this case, the taxpayer made an irrevocable election in taxable year 2006 to forgo the carryback period. Thus, the net operating losses and AMT net operating losses (“losses”) cannot be carried back to taxable years 2004 and 2005, as proposed in the RAR prepared by the revenue agent in February 2011. Rather, the losses must be carried forward to taxable years 2007 and later years consistent with the taxpayer’s election and in accordance with section 172(b)(3). However, because the statute of limitations for assessment of a tax liability and for filing a claim for refund for taxable year 2007 expired on April 15, 2011, the taxpayer cannot receive a refund of taxes for 2007. See I.R.C. §§ 6501(h) & 6511(a). Thus, we look to the mitigation provisions of I.R.C. § 1311 through 1314 to determine whether relief is available in the situation presented.

The mitigation provisions of sections 1311 through 1314 of the Internal Revenue Code were designed to palliate the effect of limitations in certain narrowly drawn situations. See Bradford v. Commissioner, 34 T.C. 1051, 1054 (1960). For an adjustment to be authorized under the mitigation provisions, there are two threshold requirements. First, there must be a determination. Second, the determination must be described by one of the circumstances of adjustment paragraphs in section 1312. In order for mitigation to apply, additional requirements in sections 1311(a) and (b) must also be met. Because the facts of this case do not meet the threshold requirements, we do not continue to determine if the remaining requirements are met.

#### Determination Under Section 1313(a)

First, there must be a determination for an open taxable year. As defined in section 1313(a), a determination is a final decision by a court, a closing agreement, a final disposition of a claim for refund, or an agreement under Treas. Reg. § 1.1313(a)-4. There is no determination at this time. However, at the conclusion of the examination of the taxpayer’s 2005 and 2006 years, the parties could satisfy this requirement by entering into a closing agreement or a mitigation agreement as defined by section 1313(a)(4). Because we find that such a determination will not satisfy the second

threshold requirement, a circumstance of adjustment under section 1312, it is not necessary to complete a closing agreement or mitigation agreement.

#### Circumstance of Adjustment Under Section 1312

Second, the determination must be described by one of the circumstances of adjustment in section 1312. There are seven circumstances under which an adjustment is authorized. These circumstances involve double inclusion of an item of gross income (section 1312(1)); double allowance of a deduction or credit (section 1312(2)); double exclusion of an item of gross income (section 1312(3)); double disallowance of a deduction or credit (section 1312(4)); correlative deductions and inclusions for trusts or estates and legatees, beneficiaries, or heirs (section 1312(5)); correlative deductions and credits for certain related corporations (section 1312(6)); and basis of property after erroneous treatment of a prior transaction (section 1312(7)).

The most relevant circumstance is found in section 1312, paragraph 4: “[t]he determination disallows a deduction or credit which should have been allowed to, but was not allowed to, the taxpayer for another taxable year, or to a related taxpayer.” If the taxpayer were to satisfy the “determination” requirement by entering into a closing agreement or mitigation agreement, the determination would generate an increased net operating loss for the taxable year 2006. However, such a determination would not allow or disallow a deduction as required by section 1312. This is because in the year the NOL is generated, the NOL is not a deduction. See I.R.C. § 172(a). A net operating loss is not a deduction until it is carried back or carried forward. See I.R.C. § 172.

Additionally, the taxpayer did not file any refund claim for years 2004 or 2005; therefore, the Exam will not disallow a claimed deduction for those years. The Exam covers years 2005 and 2006. For the 2006 year, the Exam increases the NOL that becomes available to be carried forward to 2007. Because there was never a claim to use that NOL in any year, there is no claim to allow or disallow at the conclusion of the Exam. Therefore, any determination at the conclusion of the Exam would not be described by section 1312(4). There are no other circumstances found in section 1312 that would apply to these facts. Therefore, the mitigation provisions do not apply.

Moreover, even if the taxpayer now files a refund claim to carry forward the loss to the year 2007, the mitigation provisions will still not apply. As stated above, the result of the audit is the generation of an NOL that is properly carried forward to the year 2007. Were the taxpayer to file a refund claim for 2007, the Service would deny the claim as untimely. Such a denial, when final, would be a determination as defined by section 1313(a)(3). However, this determination would not be described by section 1312(4). Section 1312(4) describes a determination that disallows a deduction or credit that should have been allowed *for another taxable year*. A denial of the refund claim for 2007 would disallow a deduction that should have been allowed in the *same* year that is the subject of the refund claim.

Revenue Agent's Report is Not a Claim for Refund

A revenue agent's report is generally made on Form 4549, "Income Tax Examination Changes." It reports the examination changes and the resulting increase or decrease to a taxpayer's income tax liability. It is not a claim for refund even when it reports a decrease to the taxpayer's tax liability that results in an overpayment due to the taxpayer.<sup>2</sup> At the time the RAR was issued, had the taxpayer claimed a refund for the 2004 and 2005 years related to the NOL carryback as described in the RAR, this analysis would change. Had the taxpayer claimed a refund for 2004 and 2005, then the determination would be a disposition on a claim for refund, as defined in section 1313(a)(3). The refund claim would be denied, as the taxpayer's final election filed with the 2006 return requires the NOL to be carried forward. The denial would disallow the NOL deduction in years 2004 and 2005. The NOL deduction should have been allowed to, but was not allowed to, the taxpayer for the year 2007. It was not allowed in 2007 because it was never claimed. This satisfies the circumstance of adjustment in section 1312(4). Therefore, the two threshold requirements would have been satisfied, and the analysis would continue.

When the circumstance of adjustment is described by paragraph 1312(4), section 1311(b) requires that, at the time the taxpayer first maintains to the Service, in writing, that he is entitled to the deduction that is ultimately denied, the deduction not be barred for the proper year. At the time of the RAR, the statute of limitations for year 2007 was open. Therefore, the requirement in section 1311(b) would have been met. Finally, section 1311(a) requires that, on the date of the determination, correction of the error described in the circumstance of adjustment be prevented by operation of law. If the statute of limitations for filing a refund claim for taxable year 2007 was closed on the date of the determination (the denial of a refund claim for 2004 and 2005), this requirement would also have been met.

Thus, had the taxpayer filed a claim for refund before April 15, 2011 for the 2004 and 2005 taxable years, relying on the NOL carryback generated in 2006 that must be carried forward to 2007, and that claim was denied after April 15, 2011, the mitigation provisions would apply to correct the error. However, the facts do not support this analysis, as the taxpayer did not file such a claim. The taxpayer did not maintain, in writing, that he was entitled to the NOL deduction in 2004 and 2005.

### CONCLUSION

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<sup>2</sup> In general, a claim for credit or refund of taxes related to a Form 1040 or 1120 is filed on a Form 1040X, Amended U.S. Individual Income Tax Return, or Form 1120X, Amended U.S. Corporation Income Tax Return, respectively. Treas. Reg. § 301.6402-3(a)(1-3). To make a refund claim relating to a Form 1120S, a taxpayer may file an additional Form 1120S and check the box indicating it is an amended return.

The mitigation provisions do not apply to the facts presented, as no circumstance of adjustment applies. Therefore, the taxpayer cannot receive a refund of the AMT paid in taxable year 2007.

Please call Rachel Gregory at (202) 622-6658 if you have any further questions.